

MACFARLANES

ISDA AUGUST 2012 DODD-FRANK PROTOCOL AGREEMENT (THE PROTOCOL)

DERIVATIVES AND TRADING

WHAT DOES THE PROTOCOL DO?

Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) and certain regulations¹ adopted thereunder by the U.S. Commodity Futures Trading Commission (the CFTC and the CFTC Rules) impose certain requirements on swap dealers and major swap participants which must be satisfied by the swap dealers/major swap participants at or prior to the time that swap transactions are entered into, amended or unwound. The notices and supplemental terms which are needed to establish compliance with the CFTC Rules depend on the legal status of the swap dealers/major swap participants' counterparties. Therefore swap dealers/major swap participants are required to obtain certain KYC from their counterparties and to verify that their counterparties qualify, for example, as eligible contract participants. As a result, swap dealers/major swap participants and their counterparties need to deliver certain information to each other in order for the swap dealers/major swap participants to satisfy the CFTC Rules.

The legal obligations are therefore applicable predominantly to the sell-side. However, if clients do not comply with the swap dealers/major swap participants' requests to deliver the relevant information, swap dealers/major swap participants will not wish to continue doing business with them.

The jurisdictional reach of the CFTC Rules is very broad and will be applicable to trading relationships between any swap dealer registered with the CFTC (which will include all leading dealers whether US based or not) and their clients.

The Protocol provides a standard set of notices, representations and covenants responsive to the CFTC Rules (and, for limited purposes, comparable non US regulatory requirements with which a swap dealer is permitted by the CFTC to comply in lieu of the relevant CFTC Rules) which can be adopted by swap dealers and their counterparties to update their swap documentation (both ISDA documentation and other governing agreements) in order to facilitate compliance with Dodd-Frank. The Protocol may also be used by a swap dealer

and a counterparty to enter into a new agreement to cover undocumented derivative transactions (these agreements are called DF Terms Agreements).

ISDA envisages there being further such protocols in the future to address the documentation impact of future rules under Dodd-Frank (including certain rules which have been published since the final rules) and the implementation of the European Market Infrastructure Regulation (EMIR). In addition, ISDA is separately publishing materials to assist market participants in complying with the disclosure requirements of the CFTC Rules.

Swap dealers will be obliged to seek additional information from their clients for compliance purposes notwithstanding the fact that such clients may not have adhered to the Protocol. In the absence of such adherence, they will do so through bespoke requests and representations in their contractual documents. As these provisions will need to be negotiated, the Protocol has been designed to save both the sell-side and the buy-side time and legal costs in implementing the CFTC requirements.

TIMING

The compliance date for most of the CFTC Rules was originally 15 October 2012. However, on 27 August 2012, the CFTC extended this deadline in respect of certain provisions of the external business conduct rule (which are the key provisions addressed by the Protocol) to 1 January 2013.

Although the deadline for many of the Dodd-Frank requirements addressed by the Protocol has been extended (and although there is also an extended exemption period in relation to certain limited requirements for non US based swap dealers that comply with certain conditions until 12 July 2013), ISDA has stressed that swap dealers will need time to assimilate the information provided by their clients by way of the Protocol into their systems before the deadline, in order to be able to trade with them afterwards. Therefore we expect that over the next three months counterparties that trade with US registered institutions will come under pressure to adhere to the Protocol or to address Dodd-Frank compliance in another way.

HOW DO YOU SIGN UP?

The ISDA adherence process for this Protocol is different to that for other ISDA protocols because adhering counterparties are required to deliver information to each other in order for adherence to be complete. Therefore, there is a two-stage process: (1) adherence to the Protocol by way of an "Adherence Letter"; and (2) delivery of a completed Questionnaire (as defined below) to each adhering counterparty with whom an adhering party wishes to amend its derivative trading relationship.

¹ CFTC, Final Rule, Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties, 77 Fed. Reg. 9734 (Feb. 17, 2012); CFTC, Final Rule, Large Trader Reporting for Physical Commodity Swaps, 76 Fed. Reg. 43851 (July 22, 2011); CFTC, Final Rule, Position Limits for Futures and Swaps, 76 Fed. Reg. 71626 (Nov. 18, 2011); CFTC, Final Rule, Real-Time Public Reporting of Swap Transaction Data, 77 Fed. Reg. 11182 (Jan. 9, 2012); CFTC, Final Rule, Swap Data Recordkeeping and Reporting Requirements, 77 Fed. Reg. 2136 (Jan. 13, 2012); CFTC, Final Rule, Swap Dealer and Major Swap Participant Recordkeeping, Reporting, and Duties Rules; Futures Commission Merchant and Introducing Broker Conflicts of Interest Rules; and Chief Compliance Officer Rules for Swap Dealers, Major Swap Participants, and Futures Commission Merchants, 77 Fed. Reg. 20128 (Apr. 3, 2012); and CFTC, Final Rule, Swap Data Recordkeeping and Reporting Requirements: Pre-Enactment and Transition Swaps, 77 Fed. Reg. 35200 (June 12, 2012).

Stage 1 - Adherence

Participants must access the "Protocol Management" section of the ISDA website and enter information online in order to generate a form of Adherence Letter. This should then be printed, signed, scanned and uploaded as a PDF to the Protocol Management system. A fee of \$500 is payable for adherence. ISDA will confirm receipt of the Adherence Letter by email and will publish a conformed copy of the Adherence Letter on its website.

The Adherence Letter is similar in form to that used in other ISDA protocols. The key difference is that parties must specify the means by which another adhering party can submit a Questionnaire (as defined below) to it for the purposes of the Protocol (i.e. by writing/fax/email/ISDA Amend (see below)).

If an agent (e.g. an investment manager) entered into the original derivative agreement on behalf of a principal, only the agent can amend the original derivative agreement by adhering to the Protocol on behalf of such principal. Similarly, if the principal itself signed the original derivative agreement, only the principal will be able to amend it by adhering to the Protocol.

Stage 2 – Exchanging Questionnaires

The adherence process is not complete after submission of the Adherence Letter. The second stage of adherence involves the adhering party completing an ISDA August 2012 DF Protocol Questionnaire (the Questionnaire) and sending it to all counterparties with whom such adhering party has a derivative trading relationship which it wishes to supplement by way of the Protocol.

Adhering parties can send different Questionnaires (i.e. completed with different information) to different counterparties. If a counterparty (1) has also adhered to the Protocol and (2) sends the adhering party a Questionnaire in return (or the adhering party returns a Questionnaire having received a Questionnaire from an adhering counterparty), the adherence process is complete and the parties' derivative agreements are deemed supplemented/created on the date on which the second party delivers its Questionnaire.

Questionnaires must be delivered no later than the 30th calendar day following the day the Protocol closes for adherence. At present ISDA has not scheduled a closing date for the Protocol, but it has the right to do so by giving 30 days' notice on its website.

WHAT HAPPENS AFTER ADHERENCE?

Once two adhering parties have exchanged Questionnaires they become "Matched PCA Parties" under the Protocol.

The Matched PCA Parties are deemed to have entered into a DF Terms Agreement (see below) if they both elect to do so in their Questionnaires.

All existing swap documentation between the Matched PCA Parties which is covered by the Protocol (including any DF Terms Agreement described above) is deemed amended by:

- ◆ incorporating DF Schedules 1 and 2 of the ISDA August 2012 DF Supplement (the DF Supplement);
- ◆ incorporating DF Schedule 3 of the DF Supplement if both Matched PCA Parties elect to do so in their Questionnaires AND if either Matched PCA Party has a "Designated Evaluation Agent", such Designated Evaluation Agent has countersigned that Matched PCA Party's Questionnaire in order to give the representations and agreements applicable to it;
- ◆ incorporating DF Schedules 4, 5 and/or 6 of the DF Supplement if both Matched PCA Parties elect to do so in their Questionnaires AND each "Designated QIR" (in the case of DF Schedule 4) or "Designated Fiduciary" (in the case of DF Schedules 5 and 6) has countersigned the relevant Matched PCA Party's Questionnaire in order to give the representations and agreements applicable to it.

See below for information about Designated Evaluation Agents, Designated QIRs and Designated Fiduciaries.

WHAT DOCUMENTS ARE INVOLVED?

The Protocol itself

This describes the mechanics set out above and provides a sample form of Adherence Letter.

The DF Supplement

This sets out standardised representations, acknowledgements, notifications, disclosures and agreements relating to the CFTC Rules which may be incorporated into adhering parties' documentation through the process described above.

- ◆ DF Schedules 1 and 2 apply to all Matched PCA Parties.
- ◆ DF Schedule 1 contains definitions.
- ◆ DF Schedule 2 contains representations and acknowledgements regarding, amongst other things, the accuracy of information provided in an adhering party's Questionnaire and consents to disclosure in order to facilitate compliance with reporting obligations under the CFTC Rules. This DF Schedule provides that adhering parties will not have additional termination rights due to information or representations provided under the Protocol, although, of course, parties will have other remedies for breach of Protocol obligations.
- ◆ Certain sections of DF Schedule 2 are only relevant to certain types of adhering party, based on the representations made in such party's Questionnaire.
- ◆ DF Schedules 3 to 6 apply to Matched PCA Parties who have elected for such schedules to apply and relate to the external business conduct rules which require swap dealers to reasonably determine the suitability of any swap recommended to a counterparty. These requirements are heightened when the counterparty is a "Special Entity" (e.g. a federal agency, municipality, employee benefits plan, endowment or governmental plan). However, the rules provide safe harbors from these requirements where the counterparty is adequately advised and will exercise independent judgement in assessing swap recommendations. The safe harbors can be satisfied in whole or part through counterparty representations of the counterparty and its relevant advisers. It is a matter for the swap dealer and counterparty to decide whether or not to make use of a safe harbor; although, there is some speculation as to the extent to which swap dealers will wish to continue transacting with counterparties who do not make use of a safe harbor. This may be less relevant to clients who transact with swap dealers on an "execution only" basis.
- ◆ DF Schedule 3 contains a general institutional safe harbor available to swap dealers and counterparties that are not themselves swap dealers or major swap participants (other than Special Entities). A party may name a Designated Evaluation Agent in its Questionnaire for the purpose of this DF Schedule. The Designated Evaluation Agent is

then required to give the representations and agreements applicable to it in DF Schedule 3 and sign the relevant party's Questionnaire. Clients wishing to make use of this safe harbor should be aware that it requires the relevant counterparty of the swap dealer to represent that it has complied with written policies and procedures designed to ensure that the person responsible for evaluating recommendations and making trading decisions on its behalf are capable of doing so. A client will have to have such written policies and procedures in place in order to utilise the safe harbor.

- ◆ DF Schedule 4 contains a safe harbor for Special Entities which are not employee benefit plans. Any such Special Entity must name a Designated QIR in its Questionnaire for the purpose of this DF Schedule. The Designated QIR is then required to give the representations and agreements applicable to it in DF Schedule 4 and sign the relevant party's Questionnaire.
- ◆ DF Schedules 5 and 6 are safe harbors for employee pension plans. The first option (Schedule 5) is specific to employee benefit plans; the second option (Schedule 6) is a version of the general safe harbor amended to cover employee benefit plans. An employee benefit plan must name a Designated Fiduciary in its Questionnaire for the purpose of these DF Schedules. The Designated Fiduciary is then required to give the representations and agreements applicable to it in DF Schedule 5/6 and sign the relevant party's Questionnaire. A swap dealer and an employee benefit plan may choose to incorporate both DF Schedule 5 and DF Schedule 6.
- ◆ "Designated Evaluation Agents", "Designated QIRs" and "Designated Fiduciaries" are advisers of an adhering party (other than a swap dealer) who exercise independent judgement in evaluating swap recommendations of the swap dealer counterparty in relation to the adhering party that are presented to it.

It is of course open to parties who wish to do so to incorporate the relevant sections of the DF Supplement in their documentation by way of bilateral negotiations, rather than by adhering to the Protocol.

The Questionnaire

The Questionnaire provides for the delivery of required information about an adhering party to its counterparties.

- ◆ Part I contains definitions.
- ◆ Part II contains basic information about the adhering party (CFTC legal identifier; name and address; principal business; guarantor information; third party control information, Designated Evaluation Agent, Designated QIR or Designated Fiduciary information, if applicable).
- ◆ Part III contains (i) representations about the status of the party (i.e. whether it is a commodity pool; an eligible contract participant; a swap dealer; a major swap participant; a financial entity; or a Special Entity); (ii) elections as to whether any of the safe harbors in DF Schedules 3 to 6 should apply; (iii) election as to whether an adhering party wishes to enter into a DF Terms Agreement.

DF Terms Agreement

This is a New York law governed agreement to which adhering parties agree their swap transactions which are not governed by an existing written agreement between them (e.g. certain FX transactions and energy transactions) shall be subject. It may be executed by an agent on behalf of a principal and it can cover transactions intended to be given up to a prime broker.

- ◆ The DF Terms Agreement automatically incorporates DF Schedules 1 and 2 and incorporates DF Schedules 3 to 6 depending on the elections of the parties in the Annex thereto in their Questionnaires. It also makes certain amendments to the DF Schedules to allow them to work with prime brokered transactions.
- ◆ The remainder of the DF Terms Agreement consists of standard representations by the parties (and their agents, if applicable) and boilerplate.

FAQS

There is a document containing FAQs on the ISDA website at the following link:
<http://www2.isda.org/functional-areas/protocol-management/faq/8/>

ISDA AMEND

ISDA and Markit have produced an automated system called "ISDA Amend" which is intended to make it easier for parties to submit and exchange information. Instead of completing the form of answer-sheet to the Questionnaire available on the ISDA website, parties can fill in a Questionnaire on-line through ISDA Amend and ISDA Amend will make the Questionnaire available to authorised parties. The system also allows investment managers to group Questionnaires according to entity type.

Although swap dealers are required to pay a fee in order to use ISDA Amend, it is free to the buy-side.

The website for ISDA Amend is:

<http://www.markit.com/en/products/distribution/document-exchange/registration.page>.

CONCLUDING THOUGHTS

As noted above, although the Protocol addresses a legal obligation of swap dealers, we assume that such entities will insist on their clients adhering to the Protocol or negotiating bespoke provisions so as to enable them to comply with the new regulatory environment. On this basis, our view is that while adhering to the Protocol and filling out the first Questionnaire will have cost and time implications, these will be mitigated by a party's ability to duplicate Questionnaires across its counterparties, rather than having to enter into fresh negotiations with each counterparty.

This note is a summary only. As the Protocol relates to US regulations, we would recommend our clients discuss the various issues raised by the Protocol with US counsel. We are happy to approach US counsel on a client's behalf if this is preferred and we can, in any event, assist with the adherence process and with liaising with sell-side counterparties on our clients' behalf.

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This note is intended to provide general information about some recent and anticipated developments which may be of interest. It is not intended to be comprehensive nor to provide any specific legal advice and should not be acted or relied upon as doing so. Professional advice appropriate to the specific situation should always be obtained.

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